ST 96-45
Tax Type: SALES TAX
Issue: Nexus (Taxable Connection With Or Event Within State)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
SPRINGFIELD, ILLINOIS

TAXPAYER	)	
	)	**Docket #**
Taxpayer	)	
	)	**IBT #**
vs	)	
	)	**Claim for Credit**
THE DEPARTMENT OF REVENUE	)	
OF THE STATE OF ILLINOIS	)	

RECOMMENDATION FOR DISPOSITION

Appearances:
Mark Stephens for TAXPAYER

Synopsis:

TAXPAYER, (the "Taxpayer") filed an Illinois combined claim for credit for Retailers' Occupation and related taxes with the Illinois Department of Revenue (the "Department") for the audit period of July 1981 to November 1992. The claim was for tax in the amount of $22,930.00. The Department denied the claim. The taxpayer protested the denial and requested a hearing. At the hearing, the taxpayer asserted that they did not have sufficient nexus with Illinois to be required to collect use tax for the State or, in the alternative, that they should only be responsible for the collection of use tax from the effective date of the act adding the franchisee language to the use tax statute. It is recommended that this matter be resolved in favor of the Department.

Findings of Fact:

1. The *prima facie* case of the Department was established by admission into evidence of the Dept. Ex. Nos. 1 - 6.

2. The taxpayer is a Delaware Corporation with its general offices and manufacturing facilities located at , W. Des Moines, Iowa 50265. (Dept. Ex. Nos. 3, 5)

3. The taxpayer operates as a franchisor and sells machinery, equipment and supplies to its franchisees located in Illinois. (Dept. Ex. No. 5; Tr. pp. 10, 16)

4. The taxpayer makes catalog sales to the franchisees in Illinois via telephone or mail-order and delivers to the franchisees via common carrier. (Dept. Ex. No. 5)

5. The license and franchise portion of the franchise agreement obligates the taxpayer to grant to the franchisee[1] the ability to perform and sell services relating to the cleaning of sewers, drains and pipes in accordance with the methods of the taxpayer and to use service marks of taxpayer within the designated area of the franchise. The agreement also states that the taxpayer will not grant an additional license or franchise within the subject territory. (Dept. Ex. No. 5)

6. The franchise arrangement also obligates the franchisee to regularly and consistently advertise and promote the services of the taxpayer. The

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[1]. The language of that portion of the franchise agreement grants "a license and franchise to perform and sell services relating to the cleaning of sewers, drains and pipes ('Services') in accordance with the methods and techniques disclosed by Company to Franchisee (all of said methods and techniques being hereinafter referred to as the 'System') solely in connection with the use of service marks of Company associated therewith (all of said service marks being hereinafter referred to as the 'Marks') within the Area of Primary Sales and Service Responsibility described in paragraph 2 of this Agreement (herein the 'Territory'). Franchisee may also, but shall not be required to, use the Marks in connection with ... other services as Company shall hereafter expressly authorize in writing. To the extent such services are offered by Franchisee, all such services shall be included with the definition of Services as set forth above and referred to throughout the Agreement. During the term of this Agreement, Company agrees not to grant an additional license or franchise for the purpose of conducting sewer, drain and pipe cleaning services within the Territory nor to establish a Company-owned business or service using the System and the Marks within the Territory. The license and franchise described in the agreement applies exclusively to the use of the Marks in the solicitation and sale of the Services using the System and does not apply to any other service marks or any trademarks of Company or the use of any of Marks in connection with the sale of any other produce or service."

agreement mandates that the media coverage must be appropriate. (Dept. Ex. No. 5)

7. The franchise agreement limits the use of the mark for the company to a manner that is prescribed by the agreement. (Dept. Ex. No. 5)

8. The franchisee is not allowed to sell, assign, transfer nor encumber the franchise agreement with the taxpayer and any sale of the franchisee's territory is conditioned upon agreement by the franchisor, the taxpayer herein. (Dept. Ex. No. 5)

9. The agreement also obligates the franchisee to advise the taxpayer of all uses of any marks similar to the name Roto-Rooter. All lawsuits for actions for infringement shall be brought only by the taxpayer, but the franchisee, if requested by the company, shall consent to be joined as a party in a lawsuit. (Dept. Ex. No. 5)

10. The franchisees purchase other things from the taxpayer such as drain cleaners for resale. Such purchases are sold at wholesale price to the franchisees who then resell the products to their customers. (Tr. pp. 16, 18 - 19)

11. Over the last ten (10) years the taxpayer has participated in three (3) industry trade shows and had one (1) conference with franchisees within the state. (Dept. Ex. No. 5)

12. The taxpayer has numerous franchisees within Illinois but was unsure as to the exact number. (Tr. p. 25)

13. When the taxpayer establishes a franchise agreement, a royalty payment is required from the franchisee for the use of the trademark. The amount of the payment is based on the population of the county or the area in which the franchise is given and in which the franchisee operates. (Tr. p. 13)

14. For the agreed upon test month of October 1990, the auditor was supplied with a list of Illinois sales totaling $17,640.33 and the accompanying invoices. The list of customers contained eleven (11) franchisees including COMPANY. (Dept. Ex. No. 5)

15. COMPANY, a sister company of the taxpayer, operates two franchises in the Chicago area as well as other independent franchises for the taxpayer. (Tr. p. 25)

16. All of the franchisees are responsible for their own advertising which is done mainly in the yellow pages. (Tr. p. 20)

17. The taxpayer does national advertising on television, radio and billboards. (Tr. p. 20)

18. It is the assertion of the taxpayer that the franchise arrangement is not sufficient representation within Illinois of the taxpayer to create the substantial nexus necessary to require the taxpayer to collect use tax in this state. (Tr. p. 15)

19. In the alternative, the taxpayer asserts that they should only be responsible for the collection of use tax from the effective date of the act incorporating the definition of "retailers maintaining a place of business in Illinois" to include the franchisee language. (Dept. Ex. No. 3)

20. The taxpayer is in agreement with the audit figures if substantial nexus is found. (Tr. p. 16)

Conclusions of Law:

The issue to be decided herein is whether the taxpayer, as a franchisor with franchisees located in Illinois, is required to collect use tax from the franchisees for the use of their product in Illinois and to remit the tax to the Department. The Use Tax Act imposes a tax "upon the privilege of using in this State tangible personal property purchased at retail from a retailer..." 35 **ILCS** 105/3. There is no issue regarding the fact that there have been sales of tangible personal property and that sale is subject to the imposition of the Use Tax Act in Illinois. However, if the taxpayer does not have sufficient association or contacts, known as nexus, with the subject state, the United States Supreme Court has stated that an imposition of collection of state tax on such a taxpayer is an abuse of portions of the United States Constitution, in particular, a violation of either the Due Process or Commerce Clause provisions.

In support of its position that its activities in Illinois are not sufficient to establish nexus, the taxpayer relies primarily upon the decision of the United States Supreme Court in National Bellas Hess Inc. v. Department of Revenue, 386 U.S. 753 (1967). The taxpayer's position is that the imposition of the requirement to collect use tax in this instance places an unconstitutional burden on the free flow of interstate commerce.

In Bellas Hess, the Department sought to impose a duty to collect use tax on a Missouri corporate retailer whose only link with Illinois was by common carrier or mail. The out-of-state retailer mailed catalogues and fliers to customers in Illinois and the customers placed orders by mail. ***Id.*** at 754-755 In finding that the Corporation did not have sufficient nexus with the State of Illinois, the United States Supreme Court cited, with approval, Miller Brothers v. Maryland, 347 U.S. 340 (1954).

In Miller Brothers, Maryland residents went to a Delaware retail outlet to purchase goods. The Court found that the State of Maryland could not impose the requirement of collection of use tax on the Delaware seller when there was no definite link between the seller and the state on which to base the liability.

The taxpayer also cites Bloomingdale's By Mail Ltd. v. Commonwealth Dept. of Revenue, 591 A.2d 1047 (Pa. 1991), ***aff'd*** 567 A.2d 773 (Pa. Commw. Ct. 1989), ***cert. denied***, 112 S. Ct. 2299 (1992) in support of its argument that there is insufficient nexus to subject it to the collection of use tax by the Department. In Bloomingdale's By Mail, the United States Supreme Court refused to review the Pennsylvania Supreme Court's holding that the state may not impose on an out-of-state mail order retailer the obligation of collecting use tax on sales made to in-state customers.

In support of his argument, the taxpayer also cites Quill Corp. v. North Dakota, 504 U.S. 298 (1992), wherein the United States Supreme Court reconsidered and reaffirmed the decision in Bellas Hess prohibiting states from imposing use tax duties on out of state sellers who have no physical presence in the taxing state. Essentially, the taxpayer's argument is that a mail-order house which does not have property or personnel in a state does not have sufficient nexus with that state to subject it to the obligation to collect use tax there.

The taxpayer is correct in the analysis of the case law he presents, however, the application to the present case and circumstances is inappropriate. In the cases cited by the taxpayer, the only connection with the states in question was as a mail order retailer.

In the instant case, the taxpayer has franchisees within the State of Illinois. The definition section of the Use Tax Act, found at 35 **ILCS** 105/2, defines a "[r]etailer maintaining a place of business in this state" to include:

> 1. A retailer having or maintaining within this State, directly or by a subsidiary, an office, distribution house, sales house, warehouse or other place of business, or any agent or other representative operating within this State under the authority of the retailer or its subsidiary,...
>
> 6. A retailer having a franchisee or licensee operating under its trade name if the franchisee or licensee is required to collect the tax under this section.

That particular language regarding the franchisee or licensee operating under the franchisor's trade name was added to the statutes by Public Act 86-261 which took effect January 1, 1990. The franchisee language was patterned after a similar section of the California statutes[2] and enacted to clarify which retailers are responsible for the collection of use tax.

Prior to the passage of Public Act 86-261, the Statute and related rules defined a retailer maintaining a place of business in this state as:

> any retailer having or maintaining within this State, directly or by a subsidiary, an office, distribution house, sales house, warehouse or other place of business, or any agent or other representative operating within this State under the authority of the retailer or its subsidiary, irrespective of whether such place of business or agent or other representative is located here permanently or temporarily, or whether such retailer or subsidiary is licensed to do business in this State.
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> It does not matter that an agent may engage in business on his own account in other transactions, nor that such agent may act as agent for other persons in other transactions, nor that he is not an

[2]. See Cal. Rev. & Tax. Code §6203(g) (Deering 1996)

> employee but is an independent contractor acting as agent. The term "agent" is broader than the term "employee". "Agent" includes anyone acting under the principal's authority in an agency capacity. ***See*** Ill. Rev. Stat. ch. 120 ¶ 439.2; 86 Admin. Code ch. 1, Sec. 150.201

The taxpayer herein admits that they had agents and franchisees in the State of Illinois during the period at issue but asserts that the portion of the Act adding the franchise language is unconstitutional or in the alternative, that they should only be responsible for the collection of use tax from the effective date of the Act.

Statutes are presumed to be constitutional and the burden of establishing the invalidity is on the challenger. The courts construe legislation so as to affirm the constitutionality if it is reasonably possible to do so. Brown's Furniture, Inc. v. Wagner, 171 Ill.2d 410 (1996)

Prior to the enactment of Public Act 86-261, the United States Supreme Court addressed the question of whether sufficient nexus is established in order to obligate a retailer to collect use tax when the taxpayer has representatives or agents in an adjoining state in Scripto v. Carson, 362 U.S. 207 (1960). The Court found sufficient nexus therein and stated, in reference to the assertion by Scripto that Miller Bros. should be controlling, that the activities in Miller Bros. were distinguishable from Scripto[3] because there was no

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[3]. The Supreme Court in distinguishing Miller Brothers in Scripto v. Carson, 362 U.S. 207 (1960) stated that:

> Miller had no solicitors in Maryland; there was no "exploitation of the consumer market"; no regular, systematic displaying of its products by catalogs, samples or the like. But, on the contrary, the goods on which Maryland sought to force Miller to collect its tax were sold to residents of Maryland when personally present at Miller's store in Delaware. True, there was an "occasional" delivery of such purchases by Miller into Maryland, and it did occasionally mail notices of special sales to former customers; but Marylanders went to Delaware to make purchases-Miller did not go to Maryland for sales. Moreover, it was impossible for Miller to determine that goods sold for cash to a customer over the counter at its store in Delaware were to be used and enjoyed in Maryland. This led the court to conclude that Miller would be made "more vulnerable to liability for another's tax than to a tax on itself". cites omitted. In view of these considerations, we conclude that the "minimum connections" not present in Miller are more than sufficient here. ***Id.*** at 212-213

"exploitation of the consumer market" and that the "minimum connections" not present in Miller were more than sufficient in Scripto.

The Supreme Court of Illinois cited Scripto with approval in Readers' Digest Association Inc. v. Mahin, 44 Ill.2d 354 (1970) ***cert. denied***, 399 U.S. 919. Reader's Digest concerned the magazine's mail order sale of books and records via United States Mail to residents of the State of Illinois. Reader's Digest had three subsidiary companies whose salesmen solicited for the parent company in Illinois. The court held that "[C]onsidering the full benefits flowing to plaintiff's aggregate business from its resident solicitors[4] and local advertising, we find without further examination of the other subsidiaries an adequate basis for use-tax liability". ***Id***. at 359 Just as the Supreme court found sufficient nexus in Scripto, which was decided many years prior to 1981, the beginning of the audit period herein, so do I find sufficient nexus herein to uphold the liability prior to the enactment of Public Act 86-261.

There are other cases relevant to a determination of whether there is sufficient nexus in this case. In National Geographic Society v. California Board of Equalization, 430 U.S. 551 (1977), California imposed a duty to collect its use tax on the mail order sales of goods by an out-of-state seller to California residents. Although the National Geographic company, as the out-of-state seller, only made the sales by mail as was done in Bellas Hess, National Geographic company also maintained two offices in California which were unrelated to the sales (the offices solicited advertising copy). ***Id.*** at 552 The California Supreme Court held that imposing the duty to collect the tax was proper because the "slightest presence" of a seller in a taxing state constituted sufficient nexus and the seller's offices in the state satisfied that test. ***Id.*** at 556-57 The United States Supreme Court specifically stated it was not agreeing with the "slightest presence" test, but found the presence

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[4]. The Court found sufficient nexus from one of the subsidiary companies and did not examine the other two resident solicitors.

of the offices established a "more substantial presence" adequate to establish sufficient nexus. *Id.* at 556

The National Geographic Court distinguished both Miller Bros. and Bellas Hess. *Id.* at 558-62 Miller Bros. did not apply because in that case, purchasers went to the out-of-state seller's out-of-state store to make the purchases and therefore the seller could not determine where the over the counter purchases would be used. *Id.* at 561-62 The Court distinguished Bellas Hess because in that case the out-of-state seller's only link to the taxing state was through the mail and by common carrier. In National Geographic the out-of-state seller did substantially more than just communicate with customers in the taxing state by mail or common carrier. *Id.* at 559 In reaching its decision, the National Geographic Court cited with approval several other cases where the requisite nexus was found including Scripto, Inc. v. Carson, 362 U.S. 207 (1960).

The taxpayer herein has numerous franchisees within Illinois. The franchisees are limited to an area of Illinois approved by the taxpayer in which to perform their business. The advertising is limited to use of the taxpayer's name. The taxpayer supervises the advertising done by the franchisees and receives full benefits flowing to taxpayer's aggregate business from its resident franchisees. I therefore find that there is sufficient nexus established here to require the taxpayer to collect use tax for the State.

I therefore recommend that the denial of the Claim for Credit be upheld in its entirety.

Respectfully Submitted,

Barbara S. Rowe
Administrative Law Judge

July 1, 1996